ABSTRACT

Professional services involve a high degree of information asymmetry: a service provider may have little information about a buyer’s valuation ex ante, and the buyer may have limited ability to verify a service provider’s effort ex post. We investigate the performance of three commonly used pricing schemes—flat fee, hourly-rate contract, and two-part tariff—in service environments where the buyer's valuation is invisible to the service provider and the provider's effort may or may not be visible to the buyer. In the private effort environment, we further distinguish between situations where the contract may be based on the outcome or on the effort reported by the provider. We show that under two-part tariff, the worst situation for the provider is contracting on outcome when effort is private. Under an hourly-rate contract, the provider may be better (worse) off in keeping effort private and contracting on reported effort than making it public when the cost of providing service is low (high); the trade-off is also affected by the degree of outcome uncertainty in a non-monotonic way. We also find that hourly-rate contracts can do as well as two-part tariffs over a sizable parameter regime when effort is private and outcome is non-contractible.

BIO

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